

State Notes

TOPICS OF LEGISLATIVE INTEREST

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Health Savings Accounts **By Julie Koval, Legislative Analyst**

Health care costs have risen dramatically over the last few years, limiting affordability and access for many people. Health care constitutes one of the largest costs for many businesses, particularly small ones, and employers are shifting an increasing share of the burden to workers or, in some cases, dropping coverage altogether. According to a Harvard University study published in the February 2005 issue of *Health Affairs*, more than half of all personal bankruptcies filed in the United States are due to medical expenses.

Some of those seeking to contain health care costs suggest that one part of the solution might be health savings accounts (HSAs). These accounts were authorized by Congress under the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (Public Law 108-173). The Act applies to tax years beginning after December 31, 2003, and allows an individual to open a tax-exempt savings account specifically for “qualified medical expenses”, i.e., amounts paid by an account beneficiary for medical care for himself or herself, or his or her spouse or dependent, to the extent that such amounts are not compensated for by insurance or otherwise. The interest gained on money in the account also is exempt from taxation.

This article discusses the Federal legislation, and describes proposals that have been introduced in Michigan to allow tax credits or deductions for HSA contributions.

Eligibility

According to the Internal Revenue Service (IRS), in order to open an HSA, an individual must meet several criteria. First, he or she must be covered by a high-deductible health plan (HDHP). Under the Act, that term means a health plan with an annual deductible of at least \$1,000 for self-only coverage or \$2,000 for family coverage. Additionally, for 2005, the sum of the annual deductible and the other annual out-of-pocket expenses required to be paid under the plan (other than for premiums) for covered benefits may not exceed \$5,100 for self-only coverage or \$10,200 for family coverage. (The Act requires that these amounts be adjusted annually to reflect a cost-of-living increase.)

Second, an individual may have no other health coverage except for insurance that covers workers' compensation, tort, or property ownership or use liabilities, or coverage for accidents, disability, dental care, vision care, and long-term care. Third, an individual may not be eligible for Medicare. Finally, an individual may not be able to be claimed as a dependent on someone else's tax return.

HSA Contributions

An individual may make contributions to an HSA tax-free subject to certain limitations established in statute, which annually must be adjusted based on the increase in the cost of living. For 2005, the monthly limitation for a person with self-only coverage is 1/12 of the lesser of the annual deductible under his or her HDHP or \$2,650. For a person with family



coverage, the monthly limitation is 1/12 of the lesser of his or her annual deductible or \$5,250. Additionally, the amount allowable as a deduction for the taxable year may not exceed the sum of the monthly limitations.

Individuals who are at least 55 years old may make additional contributions tax-free, according to a schedule. The allowable additional contribution was \$500 for 2004 and will be increased every year to a maximum of \$1,000 in 2009.

A person other than the account beneficiary may make contributions on behalf of an eligible individual. Amounts an employer contributes to an employee's HSA must be treated as employer-provided coverage for medical expenses under an accident or health plan. Contributions by an employer to an employee's HSA are exempt from employment taxes, although an employer who does not make comparable contributions to comparable participating employees' HSAs must pay an excise tax of 35% of the contributed amount.

Money in an HSA at the end of the year is carried over to the next year and is not included in the monthly or annual limitations.

HSA Distributions

Under the Act, any amount paid or distributed out of an HSA that is used exclusively to pay qualified medical expenses may not be included in gross income. An individual may use the money from his or her HSA to pay expenses that are not qualified medical expenses; however, the amount must be included in his or her gross income. Additionally, the account beneficiary must pay an extra tax equal to 10% of the amount that is distributed to pay expenses other than qualified medical expenses. (The additional 10% tax does not apply to any payment or distribution made after the beneficiary becomes disabled, turns 65, or dies.)

The Act specifies that health insurance premiums are not "qualified medical expenses", subject to certain exceptions.

The Case for HSAs

Proponents of HSAs contend that the accounts allow consumers to decide how their health care dollars are best spent, which ultimately saves money and gives consumers more control over their health care than they have with a health maintenance organization (HMO) or other traditional insurance plan. According to supporters, in addition to promoting cost consciousness, HSAs encourage beneficiaries to adopt healthier lifestyles. Under the conventional system in which employers pay insurance premiums, a patient has the same copay regardless of the source of the service and thus has little incentive to engage in comparison shopping. A patient with an HSA, however, is considered more likely to seek out the best value for his or her money, avoid costly procedures that might not be necessary, and take preventative measures against medical problems.

Health savings account advocates also contend that the accounts contribute to an increase in the number of insured people. The lower premiums that accompany the required HDHP enable families that previously could not afford it to purchase health coverage. According to



a February 2005 report by eHealthInsurance entitled “Health Savings Accounts: The First Year in Review”, in the first year that HSAs were available, 40% of the HSA-eligible plans sold through eHealthInsurance.com were purchased by people with incomes of \$50,000 or less. The most significant increase in the purchasing of HSA-eligible plans occurred among people with incomes of \$15,000 or less. Additionally, the company found that nearly one-third of the HSA purchasers, across all income levels, previously had been uninsured for at least six months.

According to HSA promoters, increased reliance on the accounts will contribute to a better health care environment even for those who do not have them, because the HSA beneficiaries will achieve savings that relieve the stress present in the overburdened system. As mentioned above, HSAs can produce savings when HSA holders adopt healthier habits and comparison shop for services. In addition, claims to be reimbursed by an HSA require less paperwork compared with traditional insurance claims, and help to reduce administrative costs. Thus, even those who find the required HDHP unaffordable or unsuitable will seek treatment in a system with more resources to serve them.

Supporters also note that HSAs are portable, following the beneficiary from job to job and providing a way to pay for necessary care during a period of unemployment. Additionally, some HSA advocates believe that the HSA concept eliminates some of the confusion that many people feel when dealing with a traditional health plan.

HSA Concerns

Some people question whether the benefits of HSAs are as great as proponents claim. Health savings accounts have been criticized as yet another way that employers are shifting the costs of health care to workers.

Some people believe that, because of the high deductible required, the accounts will appeal to healthy people and will not lead to a significant increase in the number of insured. It also has been suggested that the tax benefits gained by contributing to an HSA could be trumped by the higher out-of-pocket costs required under the HDHP.

Another concern is that most account holders are not medical experts. While an HSA beneficiary presumably will make decisions based on the advice of his or her physician, some question whether the average consumer is informed sufficiently to make the right choices in a highly technical field with serious consequences.

State Legislation

Several bills related to HSAs have been introduced in the Michigan Legislature during the 2005-2006 session.

Senate Bill 197, sponsored by Senator Bruce Patterson, would amend the Income Tax Act to allow a taxpayer to claim a State income tax credit equal to his or her contributions to an HSA, for tax years beginning after December 31, 2004. Senate Bill 198, also sponsored by Senator Patterson, would amend the Single Business Tax (SBT) Act to allow a taxpayer to

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claim an SBT credit equal to the contributions the taxpayer made to an HSA on behalf of the taxpayer or the taxpayer's employees, for tax years beginning after December 31, 2005. If the amount of the applicable credit exceeded the taxpayer's tax liability for the tax year, the excess portion of the credit could not be carried forward or refunded. The bills have been referred to the Senate Health Policy Committee.

Representative Fulton Sheen has introduced House Bill 4040, which would amend the Income Tax Act to allow an eligible individual who had established an Archer Medical Savings Account (MSA) or an HSA to deduct, to the extent not deducted in determining adjusted gross income, an amount equal to the difference between the maximum contribution amount allowed to an HSA in the tax year and the maximum deductible limit allowed for the taxpayer, not to exceed the deductible amount under the required HDHP purchased by the taxpayer actually paid in the tax year, for tax years beginning after December 31, 2004. (Archer MSAs were offered under a Federal pilot program as a precursor to HSAs.) Representative Sheen also has introduced House Bill 4041, which provides that Chapter 37 (Small Employer Group Health Coverage) of the Insurance Code would not apply to an HSA. House Bill 4040 has been referred to the House Tax Policy Committee, and House Bill 4041 has been referred to the House Insurance Committee.